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SUBJECT: SERBIA AND IMF REACH AGREEMENT

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Summary

¶1. (SBU) On November 4, the Serbian government and the IMF reached agreement on the second review of the country's $4 billion Stand By Arrangement. The IMF concluded that Serbia had met most of the economic targets, except the fiscal deficit which they agreed to expand for 2009 to 4.5% of GDP and to 4% of GDP for 2010. Serbia agreed to undertake reforms in the pension and public sector in early 2010 in order to make up for the budget revenue shortfalls. The Serbian government is satisfied with the deal, believing it will bring credibility and predictability to Serbia. Ultimately, while still in decline, the Serbian economy has performed better than expected in 2009, which allowed the IMF more flexibility in its evaluation. Serbia now must live up to its commitments and pass the expected reforms in early 2010. End Summary.

Second Review of the SBA Successfully Completed
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¶2. (SBU) Following the inconclusive August negotiations (ref A), the visiting IMF team and the Serbian government reached agreement on November 4 on the completion of the second review of the $4 billion Stand By Arrangement (SBA) with Serbia. The agreement is now subject to approval by the IMF Executive Board scheduled for December 21 provided that Serbia's Parliament adopts the 2010 budget before then. After approval, Serbia will be able to draw on the second tranche of funds from the SBA "in amount compatible with its external financing needs," according to the IMF press release.

IMF: SBA Has Worked Thus Far

¶3. (U) IMF team leader Albert Jaeger said on November 4 at a joint press conference with Serbian government officials that the SBA had helped Serbia to ease financial tensions, to contain output decline, and to face falling inflation while the large current account deficit was shrinking faster than anticipated. In line with encouraging signs in the economy, the IMF revised Serbia's projected GDP decline in 2009 from -4% to -3%, and expected modest GDP growth in 2010 of 1.5%.

Fiscal Policies Remain Key

¶4. (U) According to Jaeger, Serbia had met most of the program's targets, except the fiscal deficit, which Serbia exceeded due to revenue shortfalls. Ultimately Serbia and the IMF agreed to a 4.5% of GDP fiscal deficit for 2009 and a 4% deficit for 2010. Jaeger said the review focused on future budgets and fiscal policies.

Serbia's main problem was the continued decline in budget revenues coupled with the need for capital investments to improve ailing infrastructure. Together this created an unsustainable fiscal deficit for the years to come, Jaeger said. As a result, Jaeger said the IMF and Serbia had agreed to adjustments on the expenditure side, via freezing in pensions and public salaries throughout 2009 and ¶2010. Serbia also promised additional wage and pension reforms beginning in 2010. All of this would be done without an increase in taxes, as the Serbian government had insisted.

Government Gives Details of the Agreement

¶5. (SBU) At the press conference Finance Minister Diana Dragutinovic presented the 2010 draft budget figures blessed by the IMF showing revenues of $10.23 billion, expenditures of $11.87 billion, and a deficit of 4% of GDP $1.64 billion. National Bank of Serbia (NBS) Governor Radovan Jelasic told the media on November 5 that Serbia had agreed to cut the share of pensions in GDP from the current 13% to 10% by 2015, and to cut the share of public wages in GDP from the current 10% to 8% by 2015. Deputy Prime Minister Jovan Krkobabic of the Pensioner's Party (PUPS) stated that negotiations were tough, but agreed that the pension system reform proposal would be ready by the end of February 2010.

Economic Outlook Improving and Comparatively Good
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¶6. (SBU) The IMF's Resident Representative Bogdan Lissovolik told us on November 6 that the IMF had been encouraged by signs of Serbia's potential recovery, but acknowledged that the country "was not out of the woods yet." Lissovolik said Serbia's deficit of 4.5% looked

reasonable, compared to the higher figures in places such as the Baltic economies. For Serbia, the IMF also favorably considered expected future investments, particularly those related to Corridor 10 (ref B) and the expected expansion of Fiat's operations, which would improve Serbia's export potential. The IMF was also satisfied with Serbia's efforts to line up additional bilateral lending with China and Russia as long as they were provided at a concessional rate, Lissovolik said. Ultimately, the IMF gauged that Serbia currently had a favorable political environment which would permit the proposed reform legislation to go forward and which allowed the IMF to sign off on the next tranche, Lissovolik said. He noted, however, that the IMF team would return in February 2010 to make certain Serbia was still on track.

Figures In Line with IMF Optimism: Modest Recovery
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¶7. (U) Current statistics support the IMF's optimism. Although overall industrial production had decreased by 15% in January-September 2009 y/y, the decline stopped in August, and Serbia had a modest recovery of 3.1% in September. The increase came mostly from the processing industry: U.S. Steel production, chemicals (especially pharmaceuticals), oil derivatives, and food processing. The drop in domestic demand in Q1-Q3 2009 caused by the wage freeze, global crisis and slowdown in the economy, resulted in significant shrinking of Serbia's trade deficit by 44.5% y/y to only $5.13 billion. Consequently, the projected 2009 current account deficit dropped to only 7% of GDP, compared to 17.4% in 2008, according to NBS data. Serbia's hard currency reserves reached $15.62 billion at the end of September 2009, capable of covering an estimated nine months of imports. Inflation estimates have also been revised down and is now only expected to reach 7.7% for 2009.

IMF Funds May Not Be Needed

¶8. (U) The better-than-expected performance of Serbia's economy has changed the dynamics of the IMF program, Jaeger said, and instead of aggressive withdrawal, the IMF would disburse the remaining $3.2 billion to Serbia more evenly. Deputy Prime Minister Mladjen Dinkic said on November 5, that Serbia would not withdraw any of the remaining funds from the existing SBA, since Serbia has sufficient

currency reserves. NBS Governor Jelasic was more cautious about whether or not Serbia would call upon the additional tranche. Stojan Stamenkovic of the Economic Institute told us on November 10 that Dinkic's statement was "rubbish, and cheap political points," stating that of course Serbia needed the IMF funds.

COMMENT

¶9. (SBU) The second tranche agreement with the IMF is good news for Serbia, as it tries to recover from the economic crisis and present itself as viable, stable destination for foreign direct investment. Rather than a bill of clean health, the IMF's approval is more a signal that the situation in Serbia is less dire than elsewhere in the region. Hard work still needs to be done to reform Serbia's public sector and pension systems. The IMF will expect initial delivery of those reforms in early 2010.
End Comment.
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